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Rising Rates and Mutual Fund Investors

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The Federal Reserve kept the federal funds rate the same at its meeting on September 17, 2015, but it is expected to raise the rate in the near future. How will bond fund investors react? In this appearance on *Nightly Business Report* with Tyler Mathison, ICI Chief Economist Brian Reid explains.

Transcript

Tyler Mathison, Host, NBR: So what will rising rates mean for your mutual fund? The Fed didn't move today, but it will at some point. Here to assess how it will impact fund investors is Brian Reid, chief economist at the Investment Company Institute, the mutual fund industry's main trade group. Brian, good to have you back.

Brian Reid, ICI Chief Economist: Thank you.

Mathison: The Fed didn't raise rates today, but it did say that by 2018 it expects short-term interest rates—the Federal funds rate that it controls—to go from zero to 3 percent. What does that mean if I'm a bond fund investor? How much damage am I going to suffer to the share value of my fund?

Reid: So the focus today has been on the short-term interest rate. What's important for bond fund investors is where long-term interest rates go. The rule of thumb is, for the typical bond fund, a one percentage point increase in the long-term interest rate will reduce their overall return by about 4 percent.

Mathison: So it could be a 4 percent cut, but we do not necessarily expect that just because short-term rates go up by three percentage points that long-term rates will do the same, do we?

Reid: Typically, when the Fed begins to raise interest rates, short-term rates will move more than long-term interest rates. And the reason is that markets begin to anticipate a Fed move and they begin to price that into longer-term interest rates.

Mathison: So, if rates went up three percentage points, you're saying that that would be a 12 percent decline in my share price value?

Reid: Well, only if it occurred on one day.

Mathison: Yes, quickly.

Reid: If it’s spread out for a long period of time—let’s say over several years—remember, you’re getting interest all the time on that bond fund and that’s catching you back up to where that price movement has been.

Mathison: And there’s a lot that the bond fund manager can do tactically in that environment to blunt the impact of those rising rates, right?

Reid: Absolutely. To some extent…

Mathison: They’re going to be rolling over bonds.

Reid: They’re going to be rolling over bonds, or be bringing new bonds in that are at the higher interest rate. This begins to catch up. So when a bond fund investor has a temporary loss, it is only temporary, unless there’s a default, because interest rates eventually rise and that higher interest catches you back up to what you were before.

Mathison: But you do need to know what the duration is or the average maturity is of your bond portfolio. The longer [the maturity], generally, the more you are at risk of rising rates, right?

Reid: That’s right, the longer duration—the typical bond fund has about a four- to four-and-a-half-year duration. You should look to see what your bond fund’s average maturity rate or duration is, and see if you want to be longer or shorter.

Mathison: Brian, thank you very much.

Reid: Thank you.

Mathison: Brian Reid of the Investment Company Institute.

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